



Hillman Capital Management
4th Quarter 2011
Market Commentary

At Hillman Capital Management (HCM) we take a long-term approach to investing, focusing on the identification of companies with sustainable competitive advantage. Our goal is to purchase securities of advantaged firms when they sell at a discount to our estimates of intrinsic value. We believe that our approach offers a prudent way to control risk and outperform the market over time.

After a positive start to the year, U.S. equity markets experienced a sharp sell-off in the summer before a tide of promising U.S. economic data prompted a fourth quarter rally. The Standard and Poor's 500 TR Index returned 11.8% in the fourth quarter and 2.1% for the year. We attribute much of the acute volatility within equity markets during 2011 to a higher than normal probability of adverse shocks to economic activity. We believe that this increased probability is driven by an unhealthy combination of high debt balances, large fiscal deficits and slow growth across much of the developed world.

On March 11th, 2011 an earthquake occurred off of the Oshika Peninsula in Japan. It was the strongest to hit Japan and one of the largest earthquakes in the world since seismological record keeping began.¹ Japan's early warning system was triggered and a regional tsunami warning was broadcasted. In the areas hardest hit by the tsunami, it is estimated that residents had only about 15 minutes of warning.² The wave that struck Japan's north eastern seaboard exacted a tremendous human toll, triggered a nuclear meltdown at the Fukushima Daiichi nuclear power facility and left the coastline in ruin. On December 16th of 2011, after nine months of work to cool the reactors and contain the radioactive fallout, the Japanese Prime Minister declared that the power facility was stable. Work has begun to decommission the plant and decontaminate the surrounding areas. Japanese officials believe that this process could take decades.³

The events in Japan had an immediate global impact. Global commerce was affected by electricity rationing and parts shortages that hobbled many information technology and automotive supply chains. Additionally, the incident in Japan has caused countries to weigh safety concerns and public perception as they seek to formulate new energy policy. Future policy actions may have broader implications for nuclear regulations and the resulting global energy balance.

In some respects, the current nuclear energy debate is analogous to the debate that is still raging over financial services reform following the recent financial crisis. In both instances, policy makers are balancing public perception while looking for credible solutions to ensure that recent events will not happen again. As is often the case, decisions in these matters are not simple, solutions are costly, and change always carries the potential for further damage through the unintended consequences of new actions. Pimco's chief Mohamed El-Erian has referred to the period leading up to the financial crisis as a "great age" marked by the expansion of leverage and credit entitlement. He has also declared that we have come to the end of that great age.⁴ Like the aftermath of the Fukushima Daiichi meltdown, the leverage contaminating many balance sheets may take decades to clean up.

Throughout 2011, investors were repeatedly reminded of the structural imbalances that plague U.S. and European economies. U.S. treasury yields were volatile over the summer as the failure of political leaders to agree on terms

¹ U.S. Geological Survey.

² "Japan's earthquake warning system explained", Time Magazine, March 18th, 2011.

³ "Japan PM says Fukushima nuclear site finally stabilized", BBC, December 16th 2011.

⁴ "Navigating the Multi-Speed World: Implications for Investors", Mohamed El Erian, November 2nd 2011.

for long-term deficit reduction brought the United States to the brink of a technical default on its sovereign debt. Soon after, Standard and Poor's dropped its triple A rating on U.S. debt citing the: "weakened effectiveness, stability, and predictability of U.S. policy making and political institutions at a time when challenges are mounting" as a contributing factor.⁵ Despite legislative disunity and the Standard and Poor's downgrade, U.S. treasuries have continued to be a safe haven for many investors. Treasury prices surged in July and August of 2011 as a combination of Federal Reserve actions and fears of European sovereign defaults resulted in strong demand for treasuries. The yield on 10-year treasury securities finished the year below 2% near record lows.⁶

The European Union sovereign debt crisis intensified throughout the year. Interest rates have expanded on the sovereign debts of many euro zone countries as investors have grown increasingly wary of countries' willingness and ability to service their debts. With stagnant economies, large absolute debt levels, and ballooning fiscal deficits, many euro zone countries have few strategic options. The euro zone treaty provides for fiscal separations within a monetary union. Therefore, individual countries have no control over their own monetary policy. The European central bank has demonstrated resistance to financing the debts of countries perceived to have irresponsible fiscal policies and many countries face the need for greater fiscal austerity. Throughout the second half of 2011, fears of a European debt contagion have been palpable. Large equity and debt market gyrations have occurred based upon liquidity threats and subtle clues related to the cohesiveness of the monetary union.

Despite the challenging global economic climate, the underlying business trends in the U.S. were relatively stable throughout much of the year and leading indicators showed a slight uptick in the fourth quarter. During the year, 1.6 million net new jobs were added to non-farm payrolls.⁷ Real Gross Domestic Product expanded by an average rate of 1.2% through the first three quarters⁸ and after tax U.S. corporate profits expanded by 6.2% in the third quarter vs. the same period one year ago.⁹ Leading indicators, including the purchasing managers index and the new orders index, indicated an accelerated pace of expansion in the manufacturing sector through the month of December.¹⁰ The Conference Board's leading economic index (LEI) expanded in both October and November. Conference Board economist Ataman Ozyildirim commented that: "November's increase in the LEI for the U.S. was widespread among the leading indicators and continues to suggest that the risk of an economic downturn in the near term has receded."¹¹

We believe that U.S. consumers contributed to the resiliency of the U.S. economy in 2011. Comprising 71% of GDP, consumer spending is a vital piece of the U.S. economy. With the exception of a brief hiccup in June, the rate of personal consumption grew month over month from January to November of 2011.¹² We believe that recent trends in both income and asset values have been supportive of consumer behavior. Accelerating employment growth in the fourth quarter provided some benefit to income growth. At the same time, the combination of stabilizing home values and rising equity and fixed income markets positively influenced household net worth. Federal Reserve policy has also been supportive of recent consumer activity. Through the maintenance of low interest rates and continued balance sheet expansion the Fed has contributed to asset price stability in housing markets. Additionally, low interest rates have increased disposable income by reducing the cost of carrying debt.

⁵ "S&P Strips U.S. of top credit rating", Wall Street Journal, August 6th 2011.

⁶ U.S. Treasury, Robert Shiller Data

⁷ U.S. Department of Labor

⁸ U.S. Bureau of Economic Analysis, NIPA Tables, Percent Change From Preceding Period in Real Gross Domestic Product, seasonally adjusted annual rates.

⁹ Thomson Baseline, U.S. Bureau of Economic Analysis, NIPA basis.

¹⁰ "December 2011 Manufacturing ISM *Report On Business*", Institute for Supply Management, January 3rd, 2012.

¹¹ The Conference Board Leading Economic Index, The Conference Board, December 22, 2011

¹² BEA, NIPA Tables, Personal Consumption Expenditures, seasonally adjusted annual rates



We believe that accommodative Fed policies are likely to continue through 2012. The Fed has made clear its intentions to keep interest rates low and there is wide speculation that the Fed will initiate a third round of quantitative easing. The Fed's ability to maintain its credibility on eventual inflation avoidance is an important ingredient to the markets acceptance of low interest rates. We expect noise related to the inflationary risks of current Fed policy to continue throughout 2012.

In contrast to large U.S. sovereign debts and deficits, many major U.S. companies have healthy balance sheets and are experiencing high levels of profitability. To date, the global marketplace has offered ample opportunities for U.S. companies not only to expand sales, but also to reinforce their competitive strengths. In light of the remaining imbalances within many developed economies, the path of economic growth is likely to be choppy. Through this period, we will continue to focus our energies on the financial prospects of companies that we view to have sustainable competitive advantage and sufficient financial flexibility to weather adverse economic climates. We believe that competitively advantaged companies will outperform their peers through economic cycles and market cycles. Our goal is to invest in great enterprises at attractive prices. We will continue to invest according to this precept for the long-term interests of our clients.

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